

## Informality in Addis Ababa, Ethiopia<sup>1</sup>

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### Abstract

Ethiopian cities play an increasingly important role in economic development, both in creating value added per person and in providing a better quality of life. However, a large part of the city – the informal sector – performs much worse. This paper assesses the state of informality in Addis Ababa based on a broad definition, considering informal businesses, employment, housing, land services. We conclude that all households take part in informality as consumers and/or producers, with very high levels of informality in employment, services, land and housing. Informal businesses contribute 26% of urban employment, with relatively low and decreasing value added per person. The informal sector comprises those in exclusionary informality – where the poor resort to informality as a last resort – and those in voluntary informality – where businesses and households opt for informality based on a cost-benefit analysis. Most informality in Addis Ababa is exclusionary. The small group of businesses and households that are voluntary experience both benefits and costs. With most informality being exclusionary, formalization will not free up hidden reserves and boost the economy. As informal businesses offer services that the government can not deliver, we discuss incorporating informality into the fabric of the city. Instead of ignoring or controlling informality, formal institutions can work with informal land speculators and businesses – whom have proven to be successful – in offering services and infrastructure.

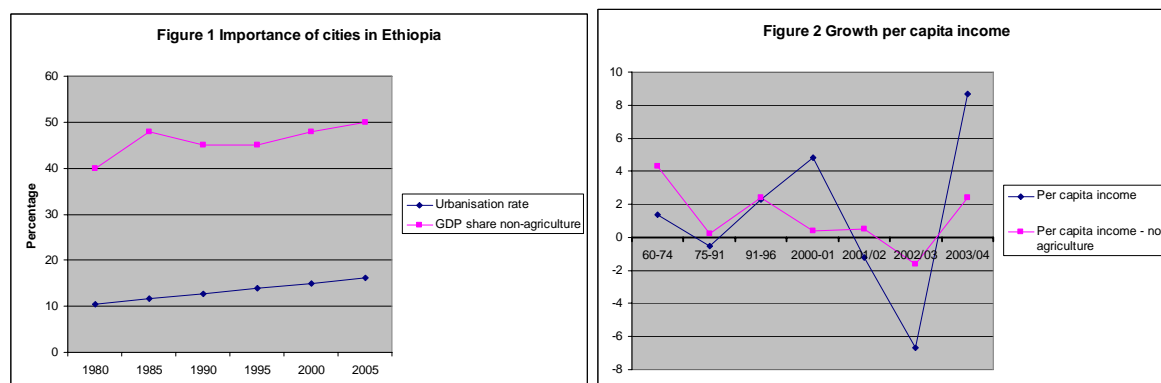
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## Introduction

After decades of political neglect, Ethiopian cities play an increasingly important role in national development. This is primarily driven by a rapid pace of urbanisation (4.3%) and a slow reduction in dependency on a volatile and low-productive agricultural sector, as depicted in figure 1. Over the past decades, Gross National Income per capita increased slowly. The growth rate is erratic, basically reflecting rainfall patterns and drought (figure 2). One would have expected a faster growth rate for the non-agriculture sector, but the rapid process of urbanisation has not been matched by an equally rapid growth of formal industries and services, pushing many into informality. Similar processes are seen across sub Saharan Africa (Bryceson and Pots, 2006; Hansen and Vaa, 2004).



Sources: EEA (2005: 113), World Bank (2008), Globalis (2008)

Addis Ababa is the capital and only prime city of Ethiopia. It houses a large informal sector, comprising informality in businesses, employment, services, land and housing. This paper aims to answer three questions: what is the state of informality across sectors? What are costs and benefits of informality? This question is answered by splitting informality into two groups: *exclusionary informality*, when businesses and households are driven into informality by poverty; and *voluntary informality*, when businesses and households opt to be informal, based on a cost-benefit analysis. And third, how can informality be incorporated into the city?

Novel aspects of this paper lie in the broad definition of informality, the application of the concepts of exclusionary and voluntary informality, as developed by Perry et al. (2007) and in the application of the relatively new concept of incorporating informality of Stren (2004). In that, the paper aims to contribute to the informal sector debate. We therefore start with an overview of the informal sector debate.

### The informal sector debate

The debate on the informal sector has been confused at best, as can be illustrated by the many different names given to it (table 1). De Soto (1989) offers the most widely used definition of informality as the unregulated, illegal and unregistered economy. Typically, informal activities are seen as lacking a legal basis and sometimes are part of the underground economy. The definition is applicable to informal businesses, employment, services, land and housing. Researchers in the housing, land and labour market have built on the definition by stressing that the dichotomy legal – illegal does not exist as many layers can be identified in between the two extremes. Only a few households have full title deeds, but many more have customary land ownership, informal rental arrangement, etc. On the bottom end households are threatened with eviction.

**Table 1 Terminology for the informal sector**

Informal sector	Informal economy
Hot sun sector	Concealed economy
Irregular sector	Extralegal economy
Marginal sector	Grey economy
Moonlight activities	Informal economy
Informality	Invisible economy
Informalization	Parallel economy
Micro-enterprises	Second economy
Self-employed	Shadow economy
Informal income opportunities	Underground economy
Petite production marchande	Unobserved and unregistered economy

Source: Van Dijk (1997) and Abdelhamid and Mahdi (2005).

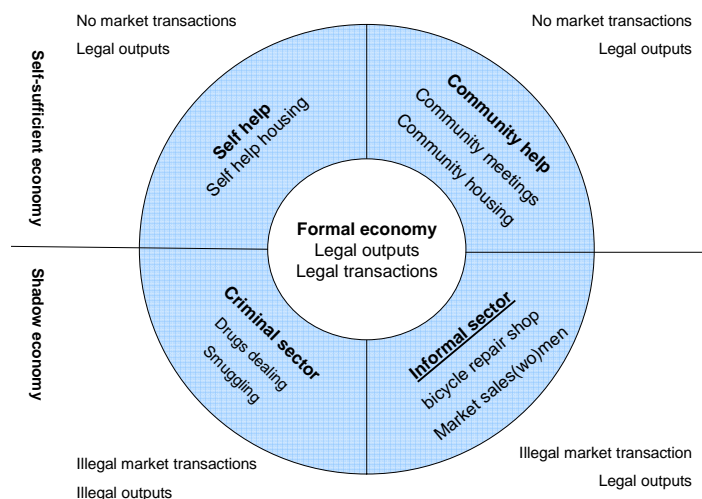
De Soto' approach reflects his profession as lawyer. He proposes to extend property rights to those who traditionally don't have these rights, thus enabling them to use their house, land and business as collateral and apply for mortgages or loans. Freeing up these hidden reserves would boost the economy. His book 'The other path' intends to provide an alternative for the guerrilla movement the shining path in his country Peru. He considers giving property rights to the poor an 'invisible revolution' in the Third world (the subtitle of his book). Informality is defined as non- or illegal, which may strictly speaking be true, but is not the way the local informal sector entrepreneurs perceive their business. Van Schendel (2006) uses the term illicit for activities which are illegal, but socially acceptable. This results in the distinctions summarized in table 2, with the informal sector being illegal but licit. As depicted in table 2, activities may also be legal but illicit, for instance if clientalism results in friends obtaining all lucrative positions or if tribal relationships determine investment flows.

**Table 2 Legal versus illegal and licit versus illicit**

Status	Legal	Illegal
<b>Licit</b>	Formal sector	Informal sector
<b>Illicit</b>	Socially unaccepted aspects of the formal sector	Criminal sector

Schneider and Enste (2002: 11) define the shadow economy in a similar way, which is seen as the sum of all illegal transactions (see figure 3). Building on this definition, the informal economy is a subset of the shadow economy characterised by illegal but socially accepted market transactions with a legal output, contrasting with criminal activities which have illegal end products. Bicycle repairman on the corner of the street, the many small traders along the roads and all kinds of small-scale transportation that can still be found in Ethiopian cities are examples of informal activities. Schneider and Enste (2002) point out that the unmeasured economy also comprises the self-sufficient economy, where legal outputs are created without any market transaction taking place. Examples include self help construction of houses and unpaid community work. The borderline between self-help approaches and informality is thus whether a market transaction takes place or not. Buying land and contracting a mason are part of the informal sector, but constructing a house yourself is not. This paper specifically excludes the self-sufficient and criminal sectors.

**Figure 3 Narrowing down the concept of the informal sector**



Source: Variation on Schneider and Enste (2002)

In their seminal work, Scheider and Enste (2002) measure the shadow economy across countries and continents. Though we don't know to what extent this comprises an informal or criminal economy, it offers a first glimpse of the size of the animal under investigation. Nigeria, with an estimated size of its shadow economy of 76% of GNP heads the pack and as expected OECD countries show the lowest percentage. Table 3 lists the size of the shadow economy across continents.

**Table 3 Size of the shadow economy in continents**

Continents	% of GNP 1989-93
Africa	44
Latin America	39
Asia	35
Former Soviet Union	25
Middle and Eastern Europe	20
OECD	12

Source: Schneider and Enste (2002: 37)

Whereas De Soto, Schneider and Enste consider informality as a manifestation of the relationship between economic agents and the state, Portes and Haller (2005) also consider it a manifestation of the relationship between economic agents and the modern economy. In their perception, which focuses solely on informal businesses, the informal sector comprises small scale, labour-intensive family enterprises, which are generally unable to accumulate assets and increase productivity or access support offered to the modern economy. Formal businesses would invest profits in their business, but informal businesses do not keep separate accounts and more often than not use income from business for school fees, foot or otherwise. Their extended families draw on the income derived from the informal business. Informality thus faces legal constraints, as mentioned by De Soto, but also faces constraints related to their informal organisational structure. Obviously taking away legal constraints is no longer seen to be sufficient to boost the economy (Hansen and Vaa, 2004; Stren, 2004; and Perry et al. (2007).

Though this line of thought has been applied to informal businesses only, it is equally applicable to other forms of informality. Services such as water and transport are regularly

provided by informal enterprises. Informal land acquisition is often, though not always small scale and generally households construct illicit housing in incremental, labour intensive processes, depending of the availability of resources in their informal business or household.

Recently, the ILO has been heavily criticized for sticking to the concept of informality instead of finding more precise measures of un/decent, un/protected work (Standing, 2008). With an unclear definition of informality, Standing argues that informality is not a proper measuring stick. The ILO is experimenting with among others the concept of vulnerable employment, which measures the extent to which employees are vulnerable to unemployment, health risks, and others (Sparreboom and de Gier, 2008). One runs the risk of measuring all non-permanent employment, with permanent employment being the top of the iceberg in most developing countries.

Since research on the informal sector started in the early seventies, considerable attention has been paid to its definition, structure and diversity. This has led Guha-Khasnobis et al. (2006) to state that the informal formal distinction is just a metaphor for a mental picture that we have of reality. *The* informal sector does not exist and hence the concept evades definition. In the late eighties and nineties the discussion evolved towards formalising the informal sector by making markets work. Key words were small scale enterprise development, cluster development and flexible specialisation. These are all tools to include informality into the formal globalising economy. The discussion fitted into the general belief in this period, following the fall of the wall of Berlin, that markets work. In the late nineties, when poverty alleviation came back on the political agendas, a very different aspect of informality came to the fore again: poor households, workers and businesses that were excluded from support services, political support and social life due to informality and hence were vulnerable to shocks such as unemployment and eviction. This group could not easily be integrated into the formal global economy.

In essence, the discussion in the eighties and nineties look at two very different faces of informality: competitive small scale businesses and a survival economy. Cunningham and Maloney (2001) call these the upper and lower tier of the informal sector. The discussions merit a deeper understanding of the two distinct forms of informality, which we call voluntary informalisation, where competitive businesses and middle-income households opt to operate underground and exclusionary informality, where the urban poor resort to informality as they are excluded from formal services.

**Table 4 Major themes in informal sector research since the '70s**

Seventies	Eighties	Nineties	2000
Issues of definition dominated the debate	Sub-sector (activity) studies were made	Interest in dynamics of small enterprises	Competitive micro & small enterprises
Dualism: only two or more sectors	Specific themes became important	Flexible specialization concept	Social and economic exclusion
The employment potential of the informal sector	Issues like credit, women in the informal sector	Issues like innovation, clusters, interfirm relations	Incorporating informality
Linkages with formal sector & constraints	Structural adjustment effects on informality	Role of networks & skilled labour	Micro finance

Source: variation on Van Dijk (1997).

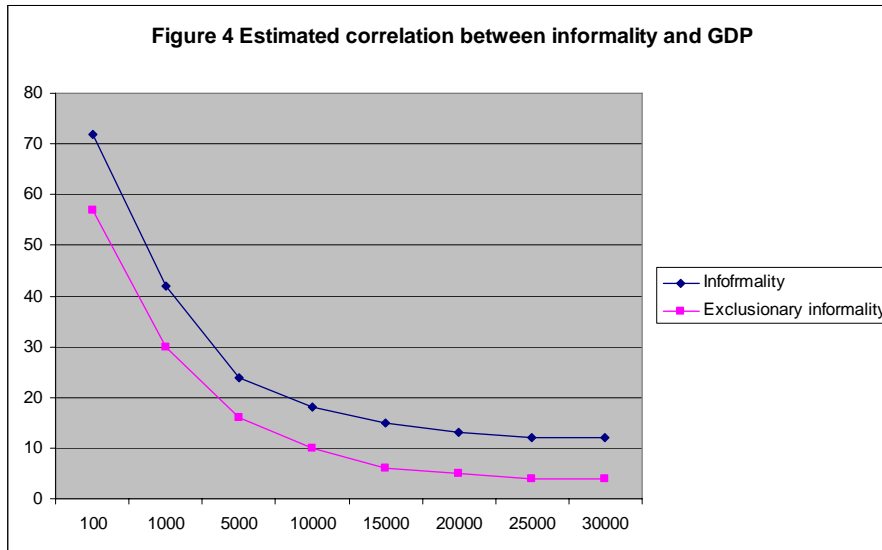
## Forms of informality

*Exclusionary informality* takes place when businesses or households use illicit market transactions due to exclusion from affordable legal opportunities. It is generally associated with poverty, vulnerability and low labour productivity (Perry et al., 2007). Applying the concept of exclusion, we argue that they are victims of discriminatory processes of markets and institutions, pushed into a state of exclusion with informal, lowly paid and unproductive work, informal and temporary housing or a life on the streets and access to only informal services, such as water, sanitation, health and education. Low education levels forces people into informal employment; related low income pushes them into informal settlements. Being excluded and informal they are vulnerable to shocks such as loss of work, evictions and violence with very limited support institutions available to them. The vulnerability of the urban poor extends beyond being informal, as they are also vulnerable to illness, natural disasters et cetera. But informality adds to their vulnerability.

As noted by Perry et al. (2007) this is not the full story of informality. Not all activities in the informal sector are survival strategies. Firms may voluntarily opt to exit the formal sector in order to fall below the radar screen of government and circumvent the regulatory burdens and taxes. This may be true for starting micro and small scale companies with growth potential and advanced technology, such as reported for information technology firms in India and China, but also for large scale companies that decide to go underground. The same processes of *voluntary informalisation* takes place in housing, land and services. For example, many middle income families in Ethiopia construct expensive houses on illegal and unserviced land to reduce costs and circumvent bureaucracy and corruption.

It should be noted that the two forms of informality – exclusion and voluntary– can be virtually indistinguishable (Perry et al., 2007). When formal housing is not available due to bureaucracy and related market failure, families have no choice but to opt for informal housing. In Ethiopia informal housing on unserviced land is more expensive than formal serviced housing which is practically unavailable due to long waiting lists and corruption. Families opt for informal housing as they have limited choice (Serbeh-Yiadom et al., 2008). By the same token, people choose to work in the informal sector if the difference in productivity between formal – informal is low, as is the case in many developing countries. The opportunity costs of being informal are low. In these cases, market failures, bureaucracy and corruption – in other words exclusionary processes –cause people to opt for informality.

With exclusionary informality particularly being an issue in developing countries, the level of informality is partially but not fully related to income per capita. Voluntary informality is of all societies. Figure 4 offers an indication of the size of informality related to linkage between Gross Domestic Product (GDP), based on studies on correlations between self employment and GDP by the ILO (in World Bank, 2007c) and data on the shadow economy by Schneider and Enste (2002). The figure also takes data on informal land, housing and services into account, with as much as 72% of the urban population in sub Saharan Africa lacks either access to legal land tenure, legally constructed houses or legal services<sup>i</sup>.



Sources: own calculations, based on Schneider and Enste (2002) and World Bank (2007c)

Whereas figure 4 depicts a strong correlation between informality and GDP, this picture needs some adjustment as the level of informality also depends on the level of inequality, the overall acceptance of illicit activities and control mechanisms of government. Countries in transition generally have relatively high levels of voluntary illegality. In resource-rich societies, GDP can be high whereas many households remain in exclusionary informality. Figure 4 broadly visualises the correlation.

### **The state of informality in Addis Ababa**

We now turn to the first question of this paper: the level and contribution of informality in Addis Ababa. Before quantifying some of the major aspects of informality across sectors however, it is important to realise that measuring informality is a complex and tricky affair. First, it takes place outside the formally registered economy and hence data is scanty and often unreliable. In Ethiopia, statistics on informality differ widely, with varying definitions and sample sizes, with errors of inclusion and exclusion and wrong quotations being the norm instead of exception. We used statistical surveys of the National Statistical Agency based on large surveys whenever possible, adding qualitative data to understand processes. Second, informality in different sectors is studied separately, with separate data sets, making it virtually impossible to correlate data.

Informality manifests itself at the level of households and businesses. Households face informality in accessing informal employment, services, land and housing; businesses in being unlicensed, not paying tax and in accessing informal housing, land and services. This section will analyse informality at these two levels.

#### *Informal households*

Informality for households in Addis Ababa is first of all crucial in accessing employment. As much as 69% of all employment in Addis Ababa and 65% of urban Ethiopia is informal (see table 5). This comprises those working in informal business, which is the rather narrow definition applied by the Ethiopian Government, as well as a huge group of domestic workers, apprentices and unpaid family workers. Those could be added to the statistics offered by the

Central Statistics Agency without errors of inclusion, as they are not working for informal businesses. It is worth pointing out that the percentages we derived at differ from those mentioned by the World Bank (2007c) and CSA (2005), who in our opinion erred by not excluding the ‘not identified’ and ‘not stated’ in their calculations. World Bank (2007c) also makes error of inclusion by adding self employed which can already be part of informal businesses.

**Table 5 Percentage of informal employment**

	<b>Addis Ababa</b>	<b>Urban</b>	<b>National</b>
At informal enterprises	26.0%	42.1%	1.1%
Domestic employee	30.2% (241,582)	7.1	1.2%
Other employed	2.4% (19,540)	0.7	0.2%
Unpaid family work	0.4%	15	Less than 10.0%
<b>Total</b>	<b>69.0%</b>	<b>64.9</b>	<b>Less than 12.5%</b>

Source: own calculations based on CSA (2005), as follows: Informal employment in informal enterprises is no of persons engaged in informal enterprises/(total employment-not identified-not stated). National statistics include urban informal employment + non agriculture rural work minus rural formal work (employers and employees of government and NGO). Total employment in Addis: 799,562; urban 3,446,092; country 31,435,108 (CSA, 2005: table 3.2).

A remarkably large group of those in informal employment are domestic employees, generally women (81%) working in what is termed elementary occupations (88%) (CSA, 2005). This is a vulnerable group, at the mercy of the household for which they work, with relatively high rates of abuse and violence. As discussions on informality generally focus on informal businesses, this group tends to remain out of the picture.

Besides the importance of informality for employment, all households take part in informal markets as consumers and users of services. This may be by shopping in Merkato, Africa’s largest informal market, employing a domestic worker, buying informal land, living in illegal or substandard housing or travelling in an informally operated minibus (see table 6). Only education is formalized to the extent that 95% are in formal education, but even then quality of education is that poor that those who can afford it opt for additional private (informal) classes. This reflects that informality is not equivalent to poor quality. In fact: informal transport is faster than formal public transport and water from venders is more expensive than piped water. The choice formal – informal reflects the unavailability of formal services.

Informal services accessed by households are particularly important in transport, health and financial services (see table 6). In these sectors informal businesses offer services which are not or inadequately provided by government. In waste collection and sewerage, households opted for self help approaches, with resp. about 50% of all waste been dumped in public spaces and pit latrines being used in the absence of a sewerage system (in Addis Ababa, 91.2% has a pit latrine or is connected to sewerage system). This also indicates the absence of formal services, creating as yet unused opportunities for (informal) business.

**Table 6 Informal households in Addis Ababa and Ethiopia**

Indicator	Addis Ababa	Urban Ethiopia	Source
Informal employment	69%	65%	See table 9.
% informal housing or land	53%	>70%	Teshome, 2008
Illegal land	29%		Teshome, 2008
Sub standard housing	33%	70%	Teshome, 2008; MoWUD, 2007
No formal piped water	60%	76%	EEA, 2005: 122; MoWUD, 2007
Transport	57%		Nyarirangwe, 2008; CSA 2004
Informal education	5%		CSA, 2004
Traditional/informal health service	27% not formal	36-49%	CSA, 2004 EEA, 2005:123
Informal financial services	50%		Capital (2008)

\* The shadow economy also includes unmeasured economic activities in agriculture.

Over 50% of all households face informality in accessing illegal land or informal housing. Houses may be informal due to the use of substandard construction material, overcrowding, illegal land tenure or informal access to drinking water and sanitation. Their quality of life is much worse than that of the city at large (see table 7). Particularly prime health indicators are alarmingly low, whereas education levels are relatively good. 49% of the informal self employed express that they are (very) satisfied with their life, with no significant difference between their satisfaction and that of formally employed or the unemployed (see table 8, World Bank 2007c: 77). It is the unemployed who significantly perceive their life to be less satisfactory.

**Table 7: quality of life and informality (data from period 1995-2005)**

	Country	Urban slums*	Urban
Children malnourished under 5 years	46.3%	46,5%	34.0%
Under five mortality rate	185	190.0	149
Measles vaccinations 12-23 months	28,8%	30.3%	63.1%
Children under 5 with diarrhea	23,3%	23,9%	16.7%
Literacy rate	35.9	64% (informal businesses)	
Literacy rate women	23,3%	55,3%	65.3%

\* Urban slums are defined as settlements with two or more deprivations. 99% of all houses have 1 deprivation.

Source: calculated based on UNDP (2007); UN Habitat (2006)

**Table 8 All things considered, how satisfied would you say you are with your life? (% respondents)**

	Inactive	Unemployed	Employee	Formal self employed	Informal self employed
Very satisfied	8	5	8	30	4
Satisfied	38	22	45	64	45
Neither	27	26	26	14	21
Dissatisfied	19	35	15	2	22
Very dissatisfied	8	11	6	0	8

Source: World Bank (2007c: 77).

## *Informal businesses in Addis Ababa*

Informal businesses in Ethiopia are defined based on three criteria: no book of accounts; no license; and fewer than 10 employees (World Bank 2007c). Registration is a first but not yet sufficient step towards licensing. Based on official statistics, 26% of those employed in Addis Ababa work in informal businesses, with another 4.8% reported as unpaid family work, other employees or so called domestic workers engaged in sales, machine operating, trade, clerks and official work. The sectors wholesale and retail trade, hotels and restaurants and primary production activities are over 90% informal, measured as a share of employment.

Businesses do not only face informality in being unlicensed, but also in accessing informal land, housing and credit. In Addis Ababa, these various levels of informality often coincide, as depicted in table 9. These multiple layers of informality indicate that informal businesses are excluded from basically all forms of government support.

**Table 9 Informal businesses**

Indicator	Addis Ababa	Urban Ethiopia	Source
% in informal enterprises	26.0%	42%	CSA, 2005
% and no of informal operators	30% (108,244)	45% manufacturing 38% trade (799,353)	MEDAC. 1999 CSA, 2003
Illegal land	44%	41.6%	Ageba and Amha, 2003
Informal credit*	55.7%	51%	CSA: 2003: 34
No access to BDS	85% of SMEs received no BDS in period 03/07	40.8%	Ageba and Amha (2003), Senshaw, 2007

\*borrowed and gifts from friends and relatives and others

\*\* Includes domestic workers working in trade, crafts, clerks, machine operations, official work.

The typical informal enterprise operator is an underemployed man (54%) living below the poverty line, scrambling to survive in a saturated market (see box 1). The majority of informal enterprises in Ethiopia are self employed, with no or very low levels of education (42.6% of employees have no education and a further 30.9% have grade 1-6; CSA 2003: 93). About 75% of all employees are unpaid family labour and 95% are paid below US\$ 18 per month. In fact 76% is paid under US\$ 6/month (CSA 2003: 103).

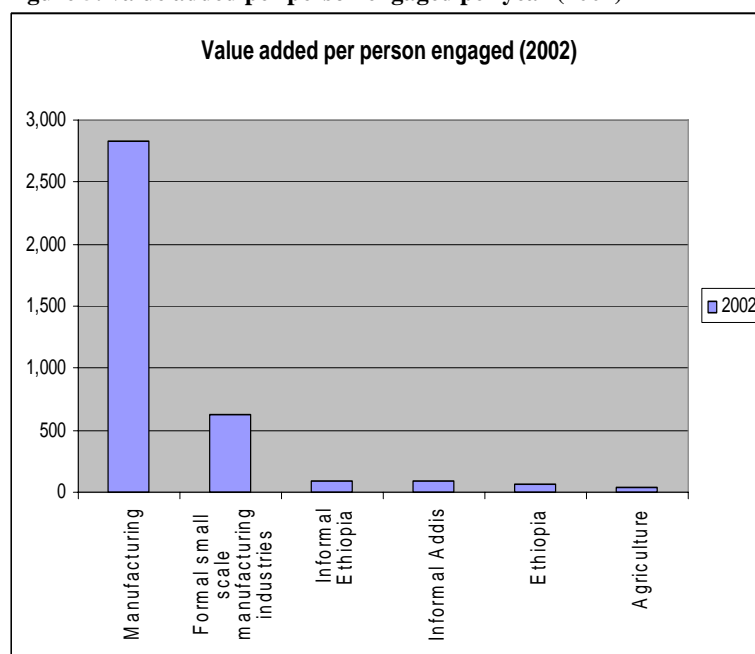
Informal businesses face low productivity levels, with limited technology development, innovation and dynamics. Value added per worker in informal enterprises is very low and comprises only 2.4% of that in large-scale enterprises (see figure 5). It is only twice as high as value added in agriculture, which is among the lowest in the world. This is closely associated with a low capacity utilisation of informal businesses of a mere 36.5% in 2001/02, with lack of demand as main reason. (EEA, 2005: 71).

### **Box 1 The typical informal business**

The typical informal business has the following characteristics: he/she works alone (82%), earns US\$ 11 per month, invested less than 250 birr as start capital (75%), is funded with informal credit (56%) or savings/inherited funds (42%), keeps no book of account (99%), operates purely on a cash base (99%), works from home (54%) or in an open space (26%) and is not formally supported financially (98%) or through business development services (59%) (EEA, 2005: 66; CSA, 2003: 34, 81; World Bank, 2007c: 80).

Productivity levels of informal businesses reduced considerably in the period 1995/96 to 2001/02, with a decrease in value added per worker of 29.6% and of fixed capital per labour in small scale manufacturing by 7.9% per year. Simultaneously the percentage of employed working for informal businesses reduced by 2% in between 1997 and 2004 (EEA, 2005: 63; World Bank, 2007c). It seems that informal business had reached its limits in absorbing the urban poor, following a sharp increase in their number since the repressive Dergh regime was ousted out of power and informal businesses were tolerated in 1991 (EEA, 2005: 127). This is in line with studies of EEA, noting that the number of workers in small scale businesses in the period 95/96 to 2001/02 also rose by just 400 per year (EEA, 2005:63).

**Figure 5: value added per person engaged per year (2002)**



Calculated based on CSA (2003), CSA (2005), EEA (2005: 46, 53, 63)

### **Exclusionary and voluntary informality in Addis Ababa**

Now we have assessed the state of informality in Addis Ababa it is time to separate exclusionary from voluntary informality. Whether informality takes the form of exclusionary or voluntary informality differs across sectors, depending on the availability and affordability of formal alternatives. We separate these two forms of informality based on the characteristics of informal businesses, land and housing. Based on the process in the land market, we will illustrate that the two forms though different are closely interwoven.

The World Bank (2007c: 81) analysed informal businesses based on 15 variables, including the educational level of the operator, why he/she chose the activity, whether the firm operates away from home, whether the firm operates 12 month of the year. These are recognised variables to separate exclusionary and voluntary informality. Exclusionary informality is estimated at 96% of the total informal employment, with median sales just below the poverty line of 1 US\$/day. As much as 81% even has median sales of a mere US\$ 20 per month. Generally, the entrepreneurs do not have any schooling. The voluntary informal have considerably higher median and mean sales, with generally some years of schooling (see table

10). As the difference between exclusionary and voluntary is a continuum, one may put the boarder line at a lower level. Then voluntary informality ranges from 4 to 15%.

**Table 10: exclusionary versus voluntary informal businesses**

	Exclusionary informal businesses	Voluntary informal businesses
Median sales	US\$ 25/ month	US\$ 332
Mean sales	US\$ 39/month	US\$ 392
Median years of schooling	0	3

Source: World Bank (2007c)

The differences between exclusionary and voluntary informal businesses are considerable. However, voluntary informal businesses don't have higher growth rates, nor are their entrepreneurs willing to take more risks than their counterparts in exclusionary informality (World Bank, 2007c). This raises the question whether informality constitutes a separate dual economy, which is effectively excluded from the state and market and hence from growth potential. The World Bank (2007c) concluded that the labour market is strongly segmented, with limited mobility between the various segments. Low productivity in informal employment is directly linked to low (formal) school enrolment ratios and poor living and working conditions in informal settlements (World Bank 2007b, World Bank 2007c). In 2003, 67% of those working in informal enterprises were illiterate (CSA 2003: 55). Despite the segmented labour market, one can not speak of a dual economy, as the market for products and services is not dualistic. All households buy from informal businesses, use informal transport or buy land informally. In many segments, the biggest challenge for informal businesses is overall market saturation. Hence, economic growth can create a larger market for all informal businesses.

In land and housing, 20% of all houses and 38% of informal houses are voluntary, defined as those with high quality houses on illegal land. Respectively 33% and 62% are exclusionary, defined as housing below standard on legal or illegal land. The percentage of voluntary informality is much higher than for informal businesses, indicating that many (middle-income) households and businesses have to resort to informality as the land market doesn't work. The same is valid for water supply, sanitation and transport. It is in those markets – where constraints to formalise are huge – that prices in informal markets are higher than in (subsidised) formal ones.

Also in land and housing the difference between voluntary houses – built up to standard – and exclusionary houses are considerable. Exclusionary informal houses are of poor quality, as depicted in table 11. Compared to other African slums, Ethiopian slums face more shortcomings, with 79.1% of Ethiopian slums combine at least two deprivations and 35.5% at least three (UN Habitat, 2006). Many of those in exclusionary informality (35%) receive remittances, generally in cash (58.7%), to supplement their income (EEA, 2005).

**Table 11 Characteristics of Ethiopian slums**

Quality of slums (2003)	Housing quality in Addis Ababa (2003)
10% of houses unfit for human habitation	33.3% unfinished floors
79% need major repairs	35.5% insufficient living area
60% has no potable water	1.6% no access to safe water source
26% no latrines at al	51.9% no improved sanitation
26% no kitchen	

Source: EEA (2005: 122), ESA (2003), UN Habitat (2008)

The restricted land market illustrates how causes of informality interrelate and how voluntary and exclusionary informality intertwine. Weak land administration and in particular inefficient land registration processes, corruption and red tape make urban land unavailable for about half of the urban dwellers and businesses. Hence, the phenomenon of parallel informal land allocation is widespread and is responsible for the alarming rate of informal settlements and related loss of revenue to the municipality (Serbeh-Yiadom et al, 2008). In the urban-rural fringe of Addis Ababa 30,000 to 60,000 houses have been constructed the past decade – all without permission, accommodating a population of about 300,000 residents or close to 10% of Addis’s population. Most (75%) were constructed in between 2002 and 2007. Land ownership can be described as illicit, in the sense that 83% receive water connections, electricity, access roads and in some cases telephone connections. The great majority (95%) pay land rents despite being illegal settlers, indicating that the governments accepted the development as a fait-a-compte. Generally (75%) the land was obtained through speculators or directly from farmers. Studies in Southern Nations in Ethiopia indicate that land prices increased tenfold after land was regularized and subdivided (Ayonga, 2008). The cost for local government is obvious: urban sprawl is combined with the need for new infrastructure and services without any land value capturing taking place. It is speculators who take the profit, whereas local governments are stuck with high transaction costs of formalizing settlements. In addition, the constraint market negatively affects growth. In rural areas, constraints in tenure security and the right to transfer land significantly affect productivity and investments (Deininger and Jin, 2004). In urban areas, the threat of eviction and weak access to land constraint investments in housing and businesses.

**Table 12 Informality in housing and land in Addis Ababa**

	Housing built to standards	Housing below standard	Total
Legal land	298,000 (47%)	150,000 (24%)	71%
Illegal land	130,000 (20%)	60,000 (9%)	29%
Total	67%	33%	

Source: Teshome (2008)

A similar process which intertwines voluntary and exclusionary informality is visible in public transport, where the government subsidizes a rather inefficient bus service, Embessa. 171 informal transport operators, with a total of about 7,500 minibuses and modified taxis offer faster informal transport, with better outreach and services (CSA 2005). A small survey concluded that for work related trips, 57% of the residents used informal minibuses. (Nyarirangwe, 2008)

### **Costs and benefits of voluntary informality**

We now turn to the second question of this paper, the costs and benefits of informality, starting with voluntary informality. This question needs to be answered before we can turn to the third question, which is how to incorporate informality. We focus on informal businesses, briefly mentioning land and housing and will include constraints in formalisation.

According to De Soto (1989) informalisation denies the operator the services that make capitalism work: access to credit, the use of business development services, professional associations and judicial courts. Informality is thus a cost; a hidden treasure that can be unleashed. Ethiopia took an important step in formalising informal businesses, when small firms, with a capital below birr 5,000 no longer needed a license. This caters for all informal businesses and should make access to services easier. In the same period (2003/04) Ethiopia

was one of the top ten reformers in start-up procedures in the world (World Bank 2007b). The ranking in doing business improved considerably, though it reduced in subsequent years as no additional reforms were introduced. Particularly registering property, exports and access to credit are relatively cumbersome (see table 13).

**Table 13 Global ranking in doing business out of 181**

	2005	2008	2009	Description
Doing business	97		116	
Starting a business	95	109	118	7 procedures (16 days) Costs: 29.8% GNI/capita
Employing workers		94	95	
Protecting investors		110	113	
Registering property	146	153	154	13 procedures (43 days)
Getting credit	83	116	123	Strong legal rights, limited credit bureaus
Paying tax	31	31	37	20 payments; total tax rate/ profit: 31.1 %
Trading across borders	149	154	152	8 documents (46 days for export)

Sources: World Bank (2007b) and World Bank (2008b)

Despite this, business development services, credit and tax exemptions as offered by the government to small scale companies are not available to informal businesses, as they are solely targeted at co-operatives. The services are indeed denied to them. In the construction sector, co-operatives buy raw materials from the government, lease equipment from the government, work on subsidised government land and housing and sell their produce to the integrated housing development programme of the government. Similar approaches are used in other sectors. In Awassa, for instance, newly established co-operatives started competition with a thriving informal home-based textile industry in 2003/04, based on free housing and free management support (Fransen, 2007). There are indications that this pushes thriving (informal) businesses out of business, replacing it by a dependent co-operative sector (Gezahegn, 2008; Fransen, 2007).

When informality comes at such a cost, why then don't businesses formalize and/or become co-operatives? Joshi and Ayee (2002) argue that informal operators demand to be part of the formal system, while Centeno and Portes (2003) stress that the informal economy is in the shadow of the state and by definition in conflict with the state. Formal and informal operators are not always keen to become co-operatives, being scared of over-dependency and interference (Gezehegn, 2008). In Ethiopia, informal operators mention three reasons in favour of formalisation and three against. In favour of formalisation are avoiding bribes and harassments, no longer having to hide and obtaining premises. Interestingly enough, access to new markets and export, credit, business development support and legal services are not seen as reasons to formalise, probably because these are unavailable for both formal and informal small businesses alike. Reasons against formalisation are to avoid tax, avoid bureaucracy and avoid high rents. 12% of the informal businesses, a number as large as all competitive informal businesses put together, don't grow for tax reasons. Though the tax regime is generally considered okay by small and medium scale business operators, many complaint about the unpredictability of setting presumptive taxes in situations without a proper book of account. In fact, ¾ of all businesses said that they do not need a license or mentioned the tax burden reason to cancel a license (World Bank 2007b:43, Gezahegn, 2008). Table 14 lists the marginal tax rates for presumptive taxes. Bureaucracy and high rents for businesses in formal land are other reasons not to formalise. Labour laws are not a consideration, indicating the limited opportunity cost in being informal.

**Table 14 Marginal tax rate for presumptive tax on business**

Annual taxable income (br)	Marginal tax rate %
1,801 – 7,800	10
7,801 – 16,800	15
16,801 – 28,200	20
28,201 – 42,600	25
42,601 – 60,000	30
60,001 and above	35

Source: IMF (2006) in World Bank (2007b: 43)

An informal business operator presently has three ways to formalise: becoming a legal business, becoming a co-operative and/or obtaining a formal premise (see table 15). None of these are ideal. The first has high costs, but still leaves him/her without access to credit, business development services and government orders. It does not solve the main constraints that business operators mention: the market is saturated: shortage of capital (28%), limited market/ market saturation (24%) and no working premise (10%) (CSA, 2003; World Bank, 2007b).<sup>ii</sup>. The second creates dependencies on the government and the third is compounded by weak land markets and high rents. In such a restrictive environment it is understandable that informality prospers.

**Table 15 Three ways for informal businesses to formalise in Ethiopia**

Type of formalization	Advantages	Disadvantages
1. Obtain legal status/ pay taxes	<ul style="list-style-type: none"> <li>No more harassment</li> <li>No more hiding</li> <li>Access to premises</li> </ul>	<ul style="list-style-type: none"> <li>Bureaucracy</li> <li>Taxes</li> <li>High rent</li> </ul>
2. Comply with current regulations for government orders	<ul style="list-style-type: none"> <li>Qualify for government orders</li> <li>Obtain a formal premise, credit, business development support</li> </ul>	<ul style="list-style-type: none"> <li>Becomes a co-operative, which creates dependency and interference</li> </ul>
3. Obtain legal title for plot or building	<ul style="list-style-type: none"> <li>No harassment</li> <li>(Can be used for mortgages)</li> </ul>	<ul style="list-style-type: none"> <li>Costly, may involve bribing</li> </ul>

For households voluntarily opting for informal land and houses the costs are even more obvious: when deciding to buy a plot of land on unserviced land, it takes at least a number of years before services are provided. In the mean time, they run the risk of harassments, corruption and eviction, similar to informal businesses. The benefits for households, as expressed in this paper, are obvious as well: informal markets offer less bureaucracy and shorter waiting time, with better value for money. As long as formal markets don't work, households and businesses will opt for informality if it has more benefits than costs.

### Costs and benefits of exclusionary informality

At the lower end are those households and businesses in exclusionary informality, whom are effectively excluded from formal services that Addis Ababa provides and hence have no choice but to be informal. They constitute up to 96% of all informal employment and 62% of all houses. Exclusionary informality and urban poverty go hand-in-hand. As the percentage of urban poverty remains constant, urban inequality levels increase and the government offers few formal services, the urban poor have no choice but to move into informality. On average over 100 (mainly poor) migrants moving into Addis Ababa per day, making the markets for employment, housing and land more and more crowded (World Bank 2007a; Tesfaye 2004 in

EEA 2005: 117). Formalization is not an option, as these households lack the resources to meet requirements for formal employment, services, land and housing. Whereas many of those in exclusionary informality are self-employed, they are in business as a survival strategy, carefully combining different coping strategies to reduce their vulnerability. These are not entrepreneurs willing to invest in their business and take risks.

Exclusionary informality has costs associated to it, in particular increased vulnerability associated with harassments (37% of informal traders in Merkato complaint of harassment according to Chu (2001)) and the risk of eviction; as well as a virtual exclusion from subsidies and government support. Subsidies for piped water and public transport reaches only a few of those who need it most, whereas the exclusionary informals pay full market prices for those services.

### **Incorporating informality: moving towards recommendations**

Informality levels in Addis Ababa are high, with most in exclusionary informality. For them, formalisation is not an option. Also for those in voluntary informality formalisation is not a realistic option as long as formal markets do not work. That brings us to the third question: how can we incorporate informality?

Stren (2004) developed the idea of incorporating informality. If you can not beat them join them he seems to advise. The informal sector provides services and products that the government can not provide with the limited resources available. For Stren, incorporating informality is a win-win situation, with those in informality benefiting from inclusion in government services, credit and government orders and with governments benefiting from informally produced services, products, housing and land. Part of informality may even be seen as a comparative advantage, in a similar vain as Amsterdam uses its narrow roads to attract tourists. Merkato, the large and colourful informal market, is a major tourist destination. By the same token many informal settlements have become much more colourful and lively than the inner city of Addis Ababa. This aspect of informality can be seen as a heritage and culture, thus incorporating informality into long term planning.

Incorporating informality builds on the benefits of informality, while taking away the costs. However, it is not quite as simple as that, as benefits for informal businesses and households, such as evading taxes, constitute a direct cost for formal institutions. Benefits of informality for officials in formal institutes include increased opportunities for corrupt practices, which in turn may paralyse formal institutions in tackling informality. Box 2 describes the ambiguous relationship between informality and formal institutions in more detail. In such a complex environment, what does incorporating informality entail?

## **Box 2 The ambiguous relationship between informality and formal institutions**

Incorporating informality is essential in overcoming the undesirable side effects of informality. Informality is ultimately undesirable for official institutions, as it erodes the tax and social security base, which can cause a vicious circle of increased taxes and/or reduced capacity at city level, thus causing companies to go underground. This ultimately weakens the economic and social foundation of cities (Schneider and Enste, 2002). In Addis Ababa informality impacts on taxes and land value capturing and hence reduced available resources for official institutions. The budgetary effect is amplified by rising costs caused by informality, associated with urban sprawl, requiring more and more capital investments and by the reversed informal process of land development (starting from inhabitation, to house construction to public infrastructure to planning). Informality is indeed a cost for formal institutions.

In reality, formal institutions are however not too enthusiastic about formalising informality, despite the many advantages. The main reason is that the provision of informal services reduces government expenditure to the extent that one may argue that the fact that part of service delivery has moved underground. It offers a safety net for the urban poor fully funded by the poor themselves. Simultaneously money earned informally is at least partly spent in the formal economy, stimulating the formal economy. Formal institutions, though at risk in the long term, thus have a vested interest in maintaining informality. This may be even more the case if systems within formal institutions have been corrupted, with informality offering endless opportunities for corrupt, unmeasured and unregistered deals. Changing these processes takes political courage. Incorporating informality, taking away its main costs, is a pragmatic way forward.

Methods to incorporate informality differ for voluntary and exclusionary informality. It is clear from the analysis of *voluntary informality*, as summarized in table 16, that incorporating the informal sector will not release huge hidden informal reserves that will boost the economy of Addis Ababa and/or lift the poor out of poverty. Formalising those in voluntary informality makes little sense without addressing structural problems of markets. For instance, land markets should be made to work in order to avail serviced land to those who can afford it. Informal land speculators and developers can work with city council in order to buy and develop (peri-urban) land for the government. They have been very successful in purchasing and developing land, but at a high cost for government (see box 2). Formally involving them may be a means to open up the land market and bring at least part of the land value capturing to official institutes.

Similarly, informal businesses can be incorporated by making markets work, if government orders would be extended to informal businesses. An enabling business environment should be in place by extending business development support, credit and legal support. This may motivate businesses to formalise and may cause the 12% of informal businesses that remain small for tax purposes to grow. Partial formalisation, i.e. only formalising registration, tax, land or labour conditions, is a means for informal businesses to slowly formalise and grow. Whereas these barriers *do* reduce growth potential, this only applies to a small segment of the informal sector.

For those in *exclusionary informality*, informality is essentially associated with poverty. There is simply not enough employment, nor enough resources to create adequate services, housing and serviced land for all. As a result, they are excluded from formal credit, services and land. Yet, it is rather cynical that the poor are not the main beneficiaries of subsidised transport, water, waste collection and other services. It is also rather cynical that postponing the investments associated with formal services increases costs in the longer term, as formalising informal settlements is more expensive than green field development, just as offering services with unlimited urban sprawl becomes expensive and unsustainable. Addis Ababa itself had some experience in micro privatisation, whereby the government subcontracts labour-based

road construction to small (informal) operators and to small co-operatives to collect waste. These experiences can be scaled up, by setting up systems in which small scale (informal) businesses offer public services on behalf of the government, subsidised or not. This can create a level playing field between formal and informal businesses and – possibly more important – offers a system to target subsidies and employment opportunities to the poor. The government can opt to increase prices of piped water and reduce prices of water kiosks and other informal operators. Various cities have experiences in what Harper (2000) labels micro privatisation. This will not lift the urban poor out of poverty but will reduce their vulnerability caused by exclusion. In other words: incorporating exclusionary informality is an important *social policy*, but is not a means for local economic development, with which it is often confused.

**Table 16 Costs and benefits of informality**

Costs of informality	Benefits of informality	Constraints to formalise
<b>Voluntary informality</b> <ul style="list-style-type: none"> <li>• Less growth to avoid taxes</li> <li>• Bribes and harassments</li> <li>• No access to government orders, credit and business development service</li> </ul>	<ul style="list-style-type: none"> <li>• Avoid tax</li> <li>• Avoid bureaucracy</li> <li>• Avoid high rents</li> </ul>	<ul style="list-style-type: none"> <li>• Taxes</li> <li>• Bureaucracy</li> <li>• High rents</li> </ul>
<b>Exclusionary informality</b> <ul style="list-style-type: none"> <li>• Risk of harassment and eviction</li> <li>• Exclusion from government support and subsidies</li> </ul>	<ul style="list-style-type: none"> <li>• Services, land and housing are available</li> <li>• In some cases, better value for money</li> </ul>	<ul style="list-style-type: none"> <li>• Formal employment, land, houses, services unavailable</li> </ul>

## Conclusions

In this paper we measured and distinguished different forms of informality in Addis Ababa and have shown their importance. The concept of informality is heterogeneous and hard to capture. Yet it puts the finger on market processes that tend to be hidden and illicit, yet impact on all. After assessing the informal sector debate, we define informality as illegal market transactions with legal outputs. It is a subsector of the shadow economy, which also includes criminal activities. We applied this definition to informal businesses, employment, services, land and housing. It is important to study informality in all these sectors, in order to offer a comprehensive overview of the state of informality. Based on this concept, the level of informality in Addis Ababa has been measured. It appears to be a vast sector, with low value added and limited innovation and dynamics. In fact, value added has reduced over time. For most it offers a quality of life far below that of the formal sector. It was also clear that information on informality is hard to find, with a lot of misguided information about.

We note significant differences between voluntary and exclusionary informality in causes and policy responses. In Addis Ababa, most informality is exclusionary, caused by poverty linked to exclusion from government support. Informality offers a safety net. Formalisation is not an option for them, as it would take too many resources to meet the standards associated with formal employment, housing, etc. A small group opts for voluntary informal businesses or informal land and housing, primarily because formal markets do not work properly. Hence, middle income families construct high quality houses illegally in the outskirts of town and business men opt for informal businesses, evading taxes and bureaucracy. For most in Addis Ababa, formalisation is not a realistic option, as formal land, houses and services is simply

hardly available. For informal businesses, becoming a co-operative would open up opportunities, but co-operatives are fully dependent on Ethiopian government which constitutes a risk.

Perry (2004) suggests incorporating informality into the fabric of the city, as formal institutes are not able to offer the services and products that informal businesses offer. This starts with recognising that informality has benefits for households and businesses. For those in voluntary informality, this first of all requires markets to work. We recommend the government to collaborate with informal businesses in making markets work: informal land speculators can avail formal land and informal businesses can offer public services. For those in exclusionary informality, incorporating informality is primarily a social policy in order to reduce their vulnerability and exclusion. Through micro privatisation services and subsidies can be targeted to them (see Harper, 2000).

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## Notes

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<sup>i</sup> A slum is defined as lacking one of the following: durable structures, sufficient space, secure tenure, safe drinking water and sanitation). (UN Habitat, 2007, p 188). As the definition includes illicit access to land and services, it offers a proxy for informality in land, housing and services.

<sup>ii</sup> Market saturation is caused by three factors: small local market, a weak export based due to low productivity levels and (unfair) competition from co-operatives, medium and small scale businesses and imported goods. Medium and large scale enterprises compete with informal businesses, based on much higher productivity levels (appr. 20 times as high). In 2004/05, 51% of these were State Owned Enterprises (SOE), down from a staggering 86% in 96/97. This still excludes an unknown number of party-affiliated enterprises (endowment companies). Particularly public utilities are controlled by SOE. Unfair competition by subsidised SOE is particularly visible in public services, such as transport and water (World Bank 2007). In some sectors, such as clothing and shoes, low cost and low quality imported products directly compete with informal operators. In a study on a cluster of leather foot ware industries in Addis Ababa, Van Der Loop (2004) concludes that 'relatively unimpeded dumping of cheap foot ware did a lot of damage to the local industry'.